

**THE PROPOSED TAKEOVER OF HYDER PLC BY
WESTERN POWER DISTRIBUTION LIMITED**

**A JOINT CONSULTATION PAPER BY THE
DIRECTORS GENERAL OF OFWAT AND OFGEM**

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PART ONE: ISSUES RAISED BY THE PROPOSED TAKEOVER

1. On 31 May 2000, Western Power Distribution Limited (“WPDL”) announced that it intended to make a cash offer for the entire ordinary share capital of Hyder plc (“Hyder”). A copy of WPDL’s Stock Exchange announcement is attached. Hyder is already subject to a recommended cash offer from St David Capital plc and a joint consultation paper setting out the issues arising from that offer was issued on 28 April 2000. WPDL has sought, but not received, a recommendation from Hyder’s board. It intends to continue discussions with Hyder and is actively seeking the recommendation of the Hyder board for its offer.
2. Hyder is a multi-utility company; it is the holding company of both Dwr Cymru Cyfyngedig (“Dwr Cymru”) and South Wales Electricity plc (“Swalec”), companies which are regulated by the Director General of Water Services (“DGWS”) and the Director General of Electricity Supply (“DGES”) respectively. This joint consultation paper discusses the regulatory issues raised by the WPDL offer and seeks the views of interested parties.
3. Hyder is believed to be the largest private sector employer in Wales. In 1996 Hyder purchased Swalec. This was followed by a more recent sale of the electricity retail supply business of Swalec to British Energy.
4. In order to provide advice to the Director General of Fair Trading on the issues raised by the proposed take-over of Hyder plc by Western Power Distribution Holdings UK, the Director General of Water Services and the Director General of Electricity Supply welcome views on the following issues.

WATER

Restructuring proposals

- What are the benefits or otherwise of separating the ownership of Dwr Cymru’s assets (and licence) from the operation of those assets? (sections 30 to 34);
- Whether the proposed contracting arrangements with United Utilities and its intention to purchase Hyder Services could lead to a compulsory water merger reference to the Competition Commission under the Water Act? (section 33);

Competition

- Whether Western Power Distribution Limited is a suitable prospective owner for Dwr Cymru? (sections 37 to 39);

- Whether the proposals for United Utilities, to provide all services to Dwr Cymru for an interim period, could lessen the value of the comparative information provided to the DGWS for Dwr Cymru and North West Water? (section 52);
- Whether the proposed licence modification requiring Dwr Cymru to maintain a financial instrument on the London Stock Exchange (“LSE”) and to publish results as required by the listing rules would address the concerns of the DGWS regarding the loss of an ordinary share listing for Hyder plc? (section 55);

Procurement proposals

- What is an appropriate timescale for the contracting-out of services to operate Dwr Cymru’s assets? How fast an exposure to competition is possible or desirable? What proportion of services should have been put out to competitive tender by the next price review?(section 45);
- What might be the appropriate contract duration for the operational, customer service and capital maintenance contracts? (section 46);
- Whether a market for the provision of the out-sourced activities will be well enough developed and contestable? In particular, is the market established to an extent that Dwr Cymru will not be dependent on a single service provider? (section 48);
- Whether United Utilities is likely to enjoy an unfair competitive advantage in any contract bidding process, given it will hold the contracts for service provision in the first instance? (section 31);
- Whether a new licence condition on procurement should be included in Dwr Cymru’s licence and, if so, whether the proposed condition is appropriate? (sections 49 to 50);

Financial ring-fencing and management independence

- Whether a new licence condition should be required prohibiting Dwr Cymru from raising any finance for its core business on terms which include cross-default covenants? (section 59);
- Whether a new licence condition should require all Dwr Cymru’s loan facilities to be maintained at investment grade ratings? (section 60);
- Whether the proposed licence amendments requiring the Dwr Cymru Board to contain three non executive directors, and to comply with the London Stock Exchange codes

relating to corporate governance are appropriate as mechanisms for strengthening management independence? (sections 61 to 62).

ELECTRICITY

- Whether this particular merger raises regulatory issues that need to be considered, such as loss comparators, loss of publicly available financial information relating to the relevant licensees?
 - Whether there are any particular issues in relation to the separation of the supply and distribution businesses?
 - Whether Swalec should be required, following the merger, to maintain in force an agreement along the lines of the proposed Multi-Utility Agreement?
 - Will the ring fencing provisions be sufficient to ensure that Swalec remains able to finance the conduct of its authorised activities by protecting it from pressures arising from the activities of its parent companies, Pennsylvanian Power and Light Corporation, and Southern Energy Incorporated?
5. Those responding should feel free to comment on whatever other aspects of the proposals they believe to be important.
 6. Respondents are asked to provide their views by Thursday 15 June 2000 in order to meet the timetable for advice required by the Director General of Fair Trading.
 7. Comments on the issues raised by Ofwat should be sent to:

Mrs Emma Cochrane
Office of Water Services
Centre City Tower
7 Hill St
Birmingham B5 4UA

email: ecochran@ofwat.gtnet.gov.uk
Fax: 0121 625 3609

8. Comments on the issues raised by Ofgem should be sent to:

Ms Rachel Graham

Ofgem
Stockley House
130 Wilton Road
London SW1V 1LQ

email: rachel.graham@ofgem.gov.uk
fax: 020 7932 5197

9. These comments will be placed in the libraries at Ofgem and Ofwat, unless they are marked as confidential. Any comments should also be copied to Stuart McGhee at the Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London, EC4Y 8JX.

I C R Byatt
Director General of Water Services

C McCarthy
Director General of Gas and
Electricity Markets

PART TWO: BACKGROUND

Regulation of mergers and take-overs

The European Merger Regulation

10. Under the European Community Merger Regulation (Council Regulation 4064/89 as amended by Council Regulation 1310/97) (“the Regulation”), a merger having a Community dimension should be appraised by the Commission of the European Union (“the Commission”) with a view to establishing whether or not it is compatible with the common market. Because of the parties’ combined world-wide and EC turnover, the proposed acquisition of Hyder by WPD appears to meet the relevant criteria for a merger having a Community dimension. The Commission has one month from the date of receipt of a complete notification to decide whether the merger raises serious doubts as to its compatibility with the common market and whether to initiate an in-depth investigation under Phase II of the Regulation.

Provisions for repatriation of the investigation to the UK

11. Article 9 of the Regulation provides for the Commission to refer a merger to the competent authorities of a Member State where:
 - a) a concentration threatens to create or to strengthen a dominant position as a result of which effective competition would be significantly impeded in a market within that Member State, which presents all the characteristics of a distinct market; or
 - b) a concentration affects competition in a market within that Member State which presents all the characteristics of a distinct market and which does not constitute a substantial part of the common market.

The competent authorities of the Member State can also make an application under Article 9 to request the Commission to refer a merger to it, setting out its reasoning for the request. The timetable for making a request and for the Commission to respond is set out in the Regulation.

12. If a merger is referred back to the Member State under Article 9, the Member State may take only measures strictly necessary to safeguard or restore effective competition in the market concerned. Unless the Commission decides to refer the merger to the UK, the UK will be precluded from applying its national legislation on competition to the merger. The EU Commission then has exclusive jurisdiction to determine whether the proposed acquisition, with or without conditions, does or does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or a substantial part of it and accordingly whether it is or is not compatible with the common market.
13. Article 21 of the Regulation provides for a Member State to take appropriate measures to protect legitimate interests other than those taken into consideration by the Regulation.

14. Article 21 provisions were employed by the UK in 1995, when Lyonnaise des Eaux SA announced its intention to purchase Northumbrian Water Group plc, in order to merge their respective water businesses in the North East of England. In this case the UK government made a successful application for the recognition of a legitimate interest in relation to sections 32 to 34 of the Water Industry Act 1991 (“the Water Act”) as amended by the Competition Service (Utilities) Act 1992.
15. Section 32 of the Water Act provides that the Secretary of State for Trade and Industry (“the Secretary of State”) must refer to the Competition Commission a merger between two water enterprises which fulfils asset value thresholds. Section 34 sets out the criteria the Competition Commission must consider in deciding whether the merger could operate against the public interest, including whether the ability of the DGWS to make comparisons between water companies would be prejudiced.
16. WPDL’s announcement of proposals that United Utilities will provide certain operational, maintenance and customer services to Dwr Cymru for an interim period and that it will acquire Hyder Services (the managed services business of the Hyder Group) raises the issue whether these arrangements give rise to a compulsory reference under the Water Act. The arrangements are set out in more detail below in the section describing the restructuring proposals for Dwr Cymru.

The role of the Regulators and Ministers

17. It is the responsibility of the Director General of Fair Trading (“the DGFT”) to advise the Secretary of State whether he should seek repatriation in order for the merger or acquisition to be referred to the Competition Commission (either under the provisions of the Fair Trading Act or as a compulsory reference under the Water Act). Alternatively the DGFT could advise that instead of such a reference, it might be appropriate for the Secretary of State to seek binding undertakings from the new owners to remedy any adverse effects the DGFT has identified. If repatriation is granted the provisions of the Fair Trading Act 1973, will automatically apply.
18. Where a merger proposal involves a regulated business, the DGFT will seek advice from the relevant Regulator (or Regulators in the case of a multi-utility), before advising the Secretary of State, on aspects of the proposal which would impact on their ability to regulate the licence holders.
19. The DGWS and DGES need to consider what advice they might give to the Government, with a view to Government drawing the attention of the EU Commission to matters relating to the merger. This paper sets out the key issues on which the Directors will need to advise. To assist them in preparing that advice, the Directors invite the comments of interested parties about those issues. However, those responding should feel free to deal with whatever other aspects of the proposals they believe to be important. If the offer were to proceed, the Regulators would need to

consider what modifications might be required to the licences held by Dwr Cymru and Swalec, in order to deal with the regulatory issues arising from the take-over. Possible licence modifications are set out in this paper.

20. The proposals, particularly the intention to separate asset ownership (and control of the licence for Dwr Cymru), are such that the issues arising from the merger are best addressed separately for the water and electricity businesses. The issues relating to water are set out in Part Three and those relating to electricity in Part Four of this paper respectively.

Details of proposed acquisition and parties involved

21. WPD, is jointly owned by PPL Corporation (“PPL”) and Southern Energy Inc. (“SEI”). SEI is a wholly owned subsidiary of the Southern Company, the largest producer of electricity in the US and which also has electricity operations on a world-wide scale. PPL operates in several energy markets in the United States and Canada and has invested world-wide in electricity distribution and generation. PPL and SEI also jointly own WPD Holdings UK (“WPD”) which is the holding company of South Western Electricity plc (now trading as Western Power Distribution), the electricity distribution business for South West England.
22. WPD intends to keep the operational headquarters of South Wales Electricity and the headquarters of Dwr Cymru in Cardiff.
23. Following completion of the Offer and subject to completion of an agreement entered into with WPD, United Utilities (through a newly formed company “UUco”) would provide certain operational, maintenance and customer services to Dwr Cymru and would acquire Hyder Services (the managed services business of the Hyder Group). United Utilities owns North West Water Limited, a licensed water and sewerage undertaker, and has experience of operating and managing water and waste water networks in the North West of England. UUco would also enter into an agreement with Swalec to provide it with certain services for a transitional period of up to one year.
24. Dwr Cymru is a water and sewerage undertaker covering an area of around 21,000 square kilometres and serving the majority of Wales with approximately 2.9 million customers. Swalec has around 0.9 million customers connected to its distribution network. The area covered by its distribution network is approximately 12,000 square kilometres, incorporating all of South Wales. Swalec is the smallest regional electricity distributor in England and Wales but has a relatively long and capital intensive network, primarily due to the geography of the area.
25. Although not part of its current proposals, an option under consideration by WPD (and also a number of other water companies which are currently looking at proposals

to separate asset ownership from operations) is the introduction of a new form of ownership for the appointed water business (such as a mutual body or other not for profit vehicle). This might be in conjunction with the introduction of a greater proportion of debt finance into the appointed business. The DGWS believes that proposals of this nature raise constitutional issues and also give rise to a fundamental point about efficiency incentives. He has today issued a separate consultation paper setting out these issues and is asking for the views of interested parties.

26. Should WPDL announce plans to sell Dwr Cymru to a not-for-profit or similar vehicle then the DGWS would expect the issues raised in that consultation paper to be clearly addressed and would seek WPDL's agreement to the further licence modifications identified in that paper. WPDL and WPD have committed to being leading distributors of electricity in the UK but have made no such commitment in relation to Hyder's water business.

Duties of the Regulators

27. The duties of the DGWS are set out in the Water Act as amended, and for DGES, in respect of the electricity industry, in the Electricity Act 1989 ("Electricity Act") and in competitive legislation. Their duties are not identical but are similar as far as the regulatory issues raised by the proposed merger are concerned.
28. The Directors' duties are to ensure that companies properly carry out their functions and that they can finance the proper provision of those services. They also have duties to protect customers. The Directors have further duties to promote efficiency and economy by the regulated businesses and to promote the efficient use of utility services by consumers. They also have duties towards the development of competition in the provision of utility services and in minimising anti-competitive behaviour in their respective industries. These powers have been recently strengthened by the Competition Act 1998.
29. An important aspect of competition is in the market for ownership and control of licensed utilities. Competition in ownership may stimulate existing owners to be more efficient in the service provided as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.

PART THREE: ISSUES FOR CONSIDERATION BY DGWS

Re-structuring proposals

30. Once certain conditions are met, WPDL intends to implement a strategy which would result in the separation of the ownership of Dwr Cymru's assets (and licence) from its operations. This would enable Dwr Cymru to introduce a new approach to service delivery.
31. Following completion of the Offer and subject to completion of formal contracting arrangements, WPD and United Utilities have agreed that a company to be acquired by United Utilities from WPD (UUco) would take up a service contract with Dwr Cymru under which UUco would provide, for an interim period, operational, maintenance and customer services to the regulated water business. UUco would purchase Hyder Services from WPD which primarily comprises the Hyder Group's business of providing managed services to a range of third party and group customers. During the period of the agreement (up to seven years), a procurement plan would be implemented under which Dwr Cymru would undertake a programme of competitive outsourcing for these activities.
32. It does not appear that the agreement (yet to be finalised) with United Utilities would result in any joint ownership of Dwr Cymru's assets and the DGWS has been told that United Utilities would not be represented on the boards of either WPDL, Hyder or Dwr Cymru.
33. The DGWS would welcome views on whether the proposed contracting arrangements and United Utilities' intention to purchase Hyder Services could be interpreted as United Utilities and Hyder ceasing to be distinct with respect to their water businesses. If this were the case then the merger would lead to a compulsory reference to the Competition Commission under the Water Act.
34. There are some parallel developments on restructuring in the gas sector but on a much smaller scale. Ofgem issued a consultation paper in January 2000¹ asking for views on BG Transco plc proposals ("Transco") to transfer three service activities to BG Technology Ltd ("BG Technology"), then to procure these services on a competitive basis. Transco and BG Technology are subsidiaries of BG Group plc. Ofgem and Transco believe the introduction of competition to these services should reduce Transco's costs.
35. However the proposals put forward by WPD appear to go much further than the Transco proposals. It is envisaged that over a set period contracts would be progressively competitively tendered, such that by the next price review a substantial

¹ *Transco Pilot Restructuring Initiatives – Technical Training, Pipeline Maintenance Centre and Engineering Services – A Consultation Document* published by Ofgem January 2000

proportion by value of Dwr Cymru's activities will have been secured through competitive tender.

36. Other issues raised by the merger are set out below.

Competition issues

Change in ownership

37. The offer involves the take-over of a licenced water undertaker by a company that has no current water interest either in the UK or abroad, although WPD does have a track record of managing a regulated utility in the UK (South Western Electricity plc).
38. As highlighted above, competition in the market for ownership and control of licensed utilities is likely to be beneficial. However the DGWS will need to be satisfied that WPDL, as prospective owner of Dwr Cymru, is a suitable company and has the operational and financial capacity to assume this role. In particular, over the next five years, Dwr Cymru must deliver, within existing price limits, an improvement programme for its water and sewerage businesses likely to cost in excess of £1 billion. The DGWS is keen to ensure that under this new ownership Dwr Cymru will remain capable of delivering such an improvement programme efficiently. The DGWS needs to form an opinion on WPDL's standing in this context and is interested to understand the views of others.
39. The DGWS will wish to be satisfied that the existing provisions of Dwr Cymru's licence, together with the further modifications proposed in this paper, may be expected to be sufficiently robust to withstand any pressures that arise as a result of the proposed change of ownership.

Market competition

40. The DGWS has a duty to facilitate effective competition between licence holders. The Competition Act 1998 has opened the prospect of increased market competition. In the water industry in particular, this is being developed through shared networks (also known within the industry as "common carriage"). The Director believes that the change in ownership for Dwr Cymru should not harm the opportunity for common carriage.
41. There is no single way of introducing market competition. The proposals do offer an alternative approach to bringing about market competition through the competitive outsourcing of the activities necessary for Dwr Cymru to deliver its service and licence obligations. The DGWS sees no reason why common carriage and competitive contracting should not sit alongside each other in delivering market competition.

Procurement

42. The outsourcing programme is an important part of WPDL's strategy for Dwr Cymru. It is a vital part of the re-structuring proposals and could be a means for achieving greater efficiency in Dwr Cymru's operations. Under the proposals Dwr Cymru would not have an operational capability and would be required to procure all operational services from outside contractors. WPDL have discussed broad proposals for procurement with the DGWS. The principles that the Director would expect to be reflected in WPDL's procurement plan for Dwr Cymru are set out below.
43. Initially all the contracts for operational, maintenance and customer services activity will be with United Utilities. It is proposed that all these contracts will be progressively competitively tendered in accordance with a formal procurement plan. The DGWS would expect there to be competitive outsourcing on a rolling basis in four main areas: service delivery and asset operation contracts; customer service contracts; capital investment contracts and contracts to design, build and operate new works.
44. The DGWS will be seeking more detailed information on the mix, type and number of contracts and their likely length. He would expect any procurement plan to be consistent with the principles set out below.

Timescale and duration

45. The DGWS will be concerned that the procurement process is designed to ensure that the costs revealed by competitive tendering for a substantial proportion and mix of all activities are available for the next price review in 2004. In terms of mix, he would expect a number of the large operational and maintenance contracts for water and sewerage works to be put out to early tender such that they were in operation by 1 April 2003.
46. In broad terms, longer contracts provide stability and could give contractors time to achieve efficiencies in their service delivery. Shorter contracts foster greater competition in service provision and so respond more quickly but do involve additional procurement and transfer costs. The Director believes that there is probably scope for the customer service contracts to be shorter than the asset operation contracts when coming to a judgement regarding optimum contract duration.
47. During the transition period as well as in the longer term it will be important for WPD and Dwr Cymru to ensure continuity of services to customers, maintenance of serviceability, and delivery of the quality improvements required by Ministers.

Cost information available at periodic reviews

48. If the cost information provided from such a tendering process is to inform the Director's judgements at price reviews as to what is an efficient level of cost, then it would need to be undertaken in an open and transparent way that does not favour any particular party. The value of the information also depends on the extent of the development of the markets that supply the services such that they are properly contestable.

New licence condition on procurement

49. In order to formalise the procurement process, the Director is proposing that a new licence condition on procurement should be included in Dwr Cymru's licence. This licence condition would require a procurement plan to be produced and updated on an annual basis. The Director would not approve the plan but would have the right to object to the plan or specific aspects of it. The operation of the licence condition would provide evidence that the competitive tendering process had been undertaken in an appropriate manner.
50. The plan should also provide the information on the timescale for competitive tendering and also details of contracts consistent with the principles outlined above. It should also set out how Dwr Cymru will ensure that the contracting process does not have a negative impact on the longer-term serviceability to customers of its water and sewerage assets. This licence condition will also require Dwr Cymru to ensure that all bona-fide potential service providers have access to the same information during the bidding process. Finally it would require Dwr Cymru to obtain the regulatory monitoring information, required by the Director, from its contractors and to ensure its reliability, together with independent certification from the independent Reporter.

Control by licensee of its operations

51. In connection with its group restructuring, initiated in 1998, whereby substantially all the utility operations and service activities of both Swalec and Dwr Cymru are being transferred to other group companies, Ofwat and Ofgem have required Hyder to enter into a number of undertakings designed to ensure that the respective utility licensees retain full operational control over their networks and utility functions. These undertakings (sometimes referred to as the Multi-Utility Agreement) are similar to those Ofgem has recently required to be given by TXU Europe and EdF International in connection with the outsourcing by Eastern Electricity and London Electricity of substantially all their network operations to a joint venture company. It will be important to ensure that WPDL and Hyder enter into similar undertakings if the merger proceeds, or the restitution of Swalec and Dwr Cymru, back to their original position.

Comparative information

52. The DGWS attaches considerable importance to his ability to use comparative information from different companies to assist in the regulation of the water companies. In his experience separate ownership of assets is key in delivering independent comparators of the highest quality. Separate ownership is maintained under these proposals. However in the short term the proposal does involve the provision of water and waste water services to two separately-owned water companies by a single service provider (United Utilities). This could lessen the value of the comparative information provided to the Director General for both Dwr Cymru and North West Water. There is also a prospective loss of stock market information (discussed below).
53. On the other hand, if Dwr Cymru proves to be a more efficient company the restructuring proposals could enhance comparative competition by creating a better comparator.
54. Following Dwr Cymru's acquisition of Swalec in 1996 the shares for the combined company, Hyder, continued to be listed on the LSE which provided both the DGWS and DGES with market information, albeit for the multi-utility. In addition, listed preference shares were issued by Dwr Cymru. If the WPDL's bid is successful, Hyder's ordinary share listing will cease. This would reduce scrutiny of Hyder's performance by the public, City analysts and shareholders. It would reduce the DGWS's ability to form judgements about how the financial markets perceive Hyder plc and its operations, of which Dwr Cymru's activities are a major component.
55. To address the concerns raised by the current proposal, the DGWS (as was required when Azurix Europe plc ("Azurix") took over Wessex Water plc ("Wessex")) would expect licence amendments to remedy such a loss of information as follows:
- A condition requiring Dwr Cymru to maintain the listing of a financial instrument (bond or preference shares) on the LSE;
 - A condition requiring Dwr Cymru to publish information about its interim and final results, as is required by the listing rules for a company with ordinary shares listed on the LSE. This condition would also require that the results and the accounts of the company should be subject to public discussion in a manner similar to a conventional Annual General Meeting.

Financial issues and ring-fencing of the regulated business

56. In all cases where there has been a significant change in corporate structure the DGWS has to consider the adequacy of the ring fence around the regulated business.

57. The parent companies of WPDL are international businesses with exposure to other ventures in other parts of the world. This could mean that, if they suffered financial constraints elsewhere, their response might impede or diminish the financial capacity of the regulated businesses. Anything that could prejudice the financial viability of Dwr Cymru would be of concern to the Director.
58. These concerns are partially dealt with by the existing licence conditions dealing with ring fencing, management and dividend policy, agreed at the time Dwr Cymru acquired Swalec to create Hyder plc in 1996. The intention was to enable the DGWS to effectively regulate the water utility within the wider group.
59. However the DGWS believes there is a case for further strengthening the ring-fencing provisions of Dwr Cymru's licence and he would expect to make modifications to prohibit it from raising any finance for its core business on terms which include cross-default covenants. Such covenants enable the lender to treat events of default on loans to other businesses within the Southern and PPL groups as triggering the requirement to repay Dwr Cymru's facilities. Similar conditions to strengthen the financial ring fence were imposed on all public electricity suppliers (PESs), including Swalec, by the DGES in 1999, following the report of the then Monopolies and Mergers Commission on the PacifiCorp/The Energy Group merger reference.
60. Additionally, following its take-over by Azurix, Wessex's licence was modified to include a condition requiring its new owners to agree that all loan facilities made available to Wessex should secure and retain investment grade ratings, or an equivalent. There are analogous clauses in the licences held by public electricity suppliers. It may be appropriate to include this in Dwr Cymru's licence.

Management of the appointed business

61. It is important that Hyder's acquisition by WPDL should not compromise the effective management of Dwr Cymru.
62. The DGWS considers that the licence for each water or sewerage undertaker should be held where the key decisions are taken. If the licence holder is a subsidiary company it should be able to demonstrate an adequate degree of independence and its directors should have clear responsibilities for regulatory matters. While most of these concerns are dealt with by existing licence conditions that strengthen the management independence of Dwr Cymru, the DGWS considers that additional modifications should be made. This is to reflect the current best practice in terms of the licence modifications that have recently been included in other water companies licences. The additional modifications are:
- increase the minimum number of independent non-executive directors on the Dwr Cymru Board from two to three; and

- require Dwr Cymru to have particular regard to any principles of good governance and code of best practice as may be incorporated into or approved for the purposes of the Listing Rules of the LSE.

PART FOUR: ISSUES FOR CONSIDERATION BY DGES

63. If WPD's offer for Hyder becomes wholly unconditional, it will result in the combination of the electricity distribution businesses of WPD and Swalec. This will give rise to a number of regulatory issues. These are considered here.
64. Ofgem's general policy towards mergers of distribution businesses has been developed over a period including the acquisition of Manweb by ScottishPower, and the merger of Scottish Hydro and Southern. To date it has not been significantly different from the principles established in the single company take-overs, such as that of London by Electricite de France. In that case, the merger was subject to a decision by the European Commission, who opined that Ofgem had the right to take regulatory action, for instance to protect the financial position of the licensee and to ensure the adequate provision of information.
65. In the August and December 1999 distribution price control documents, Ofgem acknowledged that companies were likely to seek to increase their efficiency by various methods, including various forms of combination, and that it would have to consider carefully the benefits and potential detriment arising from the loss of a comparator. Ofgem said that it was likely to recommend referral of the next relevant combination to the Competition Commission for the consideration of the general issues involved, without expressing any prejudice as to its likely position.
66. Ofgem also established in those documents an imputed annual saving of £12.5 million (reckoned as half of the estimated fixed costs of a single distribution business) to be returned to the customers of the merged entities five years after merging. This was, however, a reflection of potential efficiency saving not a tariff related to the detriment of a loss of comparator. In practice Ofgem expects the efficiency savings to be considerably greater, but these would be dealt with at the next price control in each case. The £12.5 million therefore constitutes a minimum cost benefit for customers.
67. Thus Ofgem has no track record of seeking compensation for the detriment and has effectively treated each merger to date as if it were another form of efficiency saving. It is consistent with this that Ofgem did not set the revised distribution price controls anticipating the benefits from future combinations – such a 'claw forward' policy would reduce the companies' willingness to look towards corporate solutions to improve efficiency.
68. Ofgem published a paper on 23 March 2000 setting out its decision on the London/TXU Europe Joint Venture. This also set out the principles on which future distribution–distribution mergers would be considered. In the London/TXU case, the following questions were considered and are relevant to the proposed WPD/Swalec combination:
- Does it involve a loss of comparator?

- Does it qualify for the £12.5 million customer rebate?
- What are the benefits of the combination against the loss of comparators?
- Should adjacency make a difference?

69. In the London/TXU case, Ofgem concluded that it did lead to the loss of a comparator. As such Ofgem regarded it to all intents and purposes as a merger and indicated that it intended to apply the minimum customer rebate of £12.5 million on the fifth anniversary of the transaction. Since this will fall after the next price review, the actual level of efficiency may well result in a customer benefit exceeding this value before then.

70. Ofgem also concluded that adjacency should not make a difference. Whilst the saving from adjacent PESs are likely to be greater or quicker to deliver, it seems wrong to treat more harshly a more efficient form of merger. These benefits will be discovered, if they exist, and will be useful across all of the distribution industry in subsequent price control reviews. It did not seem worth reopening the price control for what would be a relatively small amount, particularly if this dampened the companies' incentive to find efficiencies prior to the next price control.

71. Finally, Ofgem concluded that there should not be an additional customer rebate for the loss of a comparator. Even though the MMC water judgements both implied support for compensation for loss of comparator, the benefits of the merger, and their impact on the market as a whole have to be set against the deemed loss. Each case must be considered on its merits. In general, Ofgem believes best value for customers is to allow incentives to operate freely and not to impose a levy on potential efficiency. Nonetheless, Ofgem would expect combining distribution businesses to be at the frontier on both cost and quality of service.

72. In previous take-overs of PES licenceholders, undertakings have been sought from the ultimate holding companies of the acquiror to ensure that licensee subsidiaries shall at all times have available to them sufficient resources to enable each such licensee to:

- To carry on its respective licensed activities
- To comply in all respects with its obligations under its licence and the Electricity Act 1989

73. In addition, each ultimate holding company of a PES is required to give undertakings to the PES that it will not, and will procure that none of its subsidiaries will, take any action, if such action would then be likely to cause its respective licensee subsidiary to breach its obligations under its licence or the Act; and that it will procure that each of its subsidiaries will, provide promptly any information relating to any of them that its respective licensee subsidiary may from time to time require in order to:

- To comply with any requirement of Ofgem

- To assess the performance and position of a service provider with respect to the provision of any service or supply.

74. Ofgem's initial view is that similar assurances should be obtained in this case from each of SEI and PPL.

75. Ofgem will need to consider whether the proposed transaction will affect the ability of the licensee to fulfil its duties under the Electricity Act or its licence. WPD already hold the Sweb distribution licence and its owners have extensive electricity holdings in Europe and the USA.

76. Ofgem will need to re-consider Sweb and Swalec's business separation plans for distribution to ensure that they reflect the changes to the company structure or contracting arrangements following the acquisition of Swalec.

77. At the time of Hyder's acquisition of Swalec a Multi-Utility Agreement ("MUA") was proposed. The MUA was a requirement to ensure that the licensees retained full operational control over their networks and functions after the utility operation and service activities of Swalec and Dwr Cymru were transferred to other group companies. Ofgem considers it sensible that an agreement in the form of the 1999 MUA requirements remain in place at any time where any material degree of operational control of the regulated business or assets is exercised other than by the licensee.

78. Ofgem will wish to ensure that the WPDL proposal does not have any adverse effect on Swalec's ability to maintain an investment grade credit rating. Ofgem also expects that WPDL will give an undertaking to publish information about Swalec's interim and final results in accordance with the requirements of the Listing Rules applicable to listed companies.

79. Ofgem may need to consider the arrangements that emerge with the development of the business bearing in mind that WPD will hold two electricity distribution licences.